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NATIONAL MONETARY COMMISSION

Bank Acceptances

By

LAWRENCE MERTON JACOBS

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BANK ACCEPTANCES.

By Lawrence Merton Jacobs.

The fundamental difference between European and American banking has its origin in the dissimilarity between the evidences of indebtedness which lie behind the item of loans and discounts. It is most strikingly evidenced in the fact that time bills of exchange form a considerable proportion of the resources of the great banks of London, Paris, and Berlin, whereas the assets of leading New York banks are largely based on stocks and bonds.

Of the bills of exchange in which are employed, either through loans or discounts, the funds of European banks, an essential part consists of what are known as bankers' bills—that is, bills drawn on bankers and accepted by them on behalf of customers in accordance with arrangements previously made. They are bills in exchange for which, by sale to a broker or by discounting at a bank, bankers' customers or those to whom they are indebted may secure immediate credit. In some instances it is arranged that the customers themselves shall draw the bills and in others that the bills shall be drawn by third parties for their account.. In granting the accommodation the obligation that the bankers take upon themselves is that they will accept the bills upon presentation. This acceptance consists in the bankers writing across the face of the drafts the word "Accepted," adding their signature and the date. It is in the nature of a certification that the bills will be paid at maturity—that is, a specified

number of days or months from the date appearing in the acceptance, or three days later if grace is allowed, as in England. When a banker grants accommodation to a customer by means of an acceptance, he may secure himself in various ways. Ordinarily a banker accepts a customer's draft merely upon his general responsibility, the banker's risk being much the same as if he had discounted the customer's note running a certain length of time. Where the customer is an importer, the banker ordinarily accepts the drafts upon the delivery to him of the documents covering the shipment, which documents he then turns over to his customer against a trust receipt. When a credit of this kind is opened, the usual practice is for the banker to require the signature of a form containing an agreement to hold him harmless for accepting the bills, to place him in funds sufficient to pay off the bills three days prior to their maturity, and to pay him a commission on the transaction, this commission varying according to the length of time the bills are to run and the financial standing of the customer. The cost of the accommodation to the customer is this commission plus the prevailing rate of discount for bankers' bills.

In the United States the national bank act does not permit banks to accept time bills drawn on them. Although the act does not specifically prohibit such acceptances, the courts have decided that national banks have no power to make them. This restriction has had a very considerable influence upon the development of banking in this country. For some time after the passage of the national bank act, merchants and manufacturers provided themselves with funds by discounting their

promissory notes with their local banker. Gradually, however, many concerns, finding that their needs were outstripping the banking accommodation which they could secure in their immediate vicinity, came to place their notes in the hands of brokers who in turn disposed of them to such bankers as possessed greater surpluses than they could satisfactorily invest at home. It is this method of borrowing which is now largely employed. In other words, the prohibition of bank acceptances has led to the creation of a vast amount of promissory notes instead of time bills of exchange. The difference between these two classes of instruments accounts to a great extent for the difference between European and American banking. In the case of time bills of exchange drawn on and accepted by prime banks and bankers there is practical uniformity of security. In the case of our promissory notes or commercial paper there is no such uniformity, the strength of the paper depending on the standing of miscellaneous mercantile and industrial concerns.

It is this uniformity of security, on the one hand, which makes possible a public discount market; it is the lack of it in single-name paper which makes such a market impossible. As a result, we have great discount markets in London, Paris, and Berlin, and none in New York. In European centers the discount rate is the rate upon which the eyes of the financial community are fixed. In New York it is the rate for day-to-day loans on the Stock Exchange. The advantage in character of the one rate over the other clearly indicates an important advantage of European banking systems over our own. In the first

place, the European discount rate bears a very direct relation to trade conditions. Its fluctuations depend primarily on the demand for and supply of bills which owe their origin to trade transactions, as balanced against the demand for and supply of money. If trade is active the supply of bills becomes large, rapidly absorbing the loanable funds of the banks. As these surplus funds become less and less banks are unwilling to discount except at advanced rates. If trade is slack, less accommodation from bankers in the way of acceptances is required, bills become fewer in number, the competition for them in the discount market more keen, and the rate of discount declines. Low rates are an incentive to business and advancing rates act as a natural check. The New York call-loan rate, on the other hand, bears only an indirect relation to trade conditions. Its day-to-day fluctuations register mainly the speculative and investment demand for stocks. Low rates, instead of being an incentive to the revival of trade, are rather made the basis for speculative operations in securities.

The striking difference, however, between European discount rates and the New York call-loan rates is that the former are comparatively stable and the latter subject to most violent oscillations. Foreign discount rates as bank reserves become depleted advance by fractions of 1 per cent. In New York the money rate advances on occasion 10 per cent at a time, mounting by leaps and bounds from 20 per cent to 100 per cent in times of stress.

There are two principal reasons for the stability of foreign discount rates. In the first place, trade expands and contracts gradually, so trade bills multiply or diminish in

number little by little, producing a gradual increase or decrease in the demand for money. In the second place, discount rates are steady because there is a free movement of funds between the countries possessing great discount markets. Between London and Paris money flows as the balance of indebtedness changes, modified by the discount rates at the respective centers. If France owes England more than England owes France, money will tend to flow from Paris to London in settlement of this balance of indebtedness. If the London discount rate is higher than that of Paris, the movement will be accentuated by the movement of French funds to London for investment in sterling bills of exchange—that is, in bills drawn on and accepted by prime English banks and bankers. If the Paris discount rate is higher than that of London, there will be a natural offset to the tendency of funds to move to London in settlement of this balance of indebtedness. Briefly, money seeks investment in those centers where the discount rates are highest. If the discount rate in Paris is 1½ per cent and 2¾ per cent in London, Paris bankers remit funds to London for investment in sterling bills. This increases the supply of money competing for bills in London and forces the discount rate downward. At the same time the drain of funds from Paris results in lessening the competition for bills in that center and the Paris discount rate rises. Thus it is that funds freely move to and fro between London, Paris, Berlin and Amsterdam, an exact equality in rates being prevented largely by the fact that the discount markets in these cities differ in size and that there is not in each an equally free market for gold. For example, the Paris discount

market is broader than that of Amsterdam, and there is consequently less risk in exchange in forwarding funds to Paris for investment than to Amsterdam. That the Paris discount rate should rule somewhat lower than that of Amsterdam is accordingly natural. Sterling bills, moreover, are favored above German bills because London possesses a freer market for gold than does Berlin—that is, a holder of credit in London can count on being able not only to convert it into gold, but to withdraw the gold, whereas artificial restrictions are sometimes placed on the withdrawal of gold from Germany. In consequence, apart from any consideration as to relative size of the two money markets, there is a tendency for funds to remain in or to move to London even when the Berlin discount rate is slightly higher.

There are likewise two principal reasons for the instability of the money rate in New York. The first is that the demand for loans for the purpose of speculative operations in stocks does not increase gradually. A few weeks at most are sufficient for a large speculative movement to develop. At the same time the profits in successful stock speculation are so great compared with those in trade that the matter of whether the call rate is 6 per cent or 10 per cent is relatively unimportant. So it is that only very sharp and very considerable advances in the call rate are effective in checking the demand for money. The second reason is that an advance in the call rate above the level of foreign discount rates does not serve directly to attract funds from Europe. The continuance of high rates can not be depended upon, and furthermore, while London bankers, for example, may be willing to

loan money to finance speculative movements at home, to make advances for similar purposes abroad is quite another matter. In fact, the higher the call rate is the less the European banker is inclined to lend his money in the New York market. New York is in a class by itself. Without bank-accepted bills it can have no discount market. Without a discount market funds can not move to it as they do between the financial centers of Europe, because there are no bank-accepted bills in which foreign banks can invest. Our commercial paper is not suitable. Foreign banks will not purchase it because they are not acquainted with or sure of the rating of miscellaneous mercantile establishments and because such paper could not be readily disposed of in case it became necessary or profitable to withdraw funds from New York for remittance elsewhere.

The weakness of our banking system as compared with the systems of Europe may very certainly be attributed in part to the omission of the bank act to permit bank acceptances. It is a weakness, furthermore, which involves the country in serious economic loss. Without a national discount market, the great majority of our merchants and manufacturers are compelled to confine their borrowings to American capital, either through the discounting of their paper with their local banks or through its sale to note brokers. All but the strongest and largest are practically excluded from the benefits of foreign competition for their paper. Aside from the great concerns with international ramifications, which are able to arrange their own credits abroad, our merchants and manufacturers are not benefited by low foreign discount rates,

except in so far as note brokers, who make it a practice to borrow in Europe with commercial paper as collateral, are better able to finance their purchases. What is more, they receive relatively little advantage from an accumulation of funds in New York banks. Low call loan rates have an indirect rather than a direct effect on the rate which the mercantile community has to pay for money. Low call rates, in other words, are an indication more especially of stagnation in the stock market than of a lack of demand for accommodation from merchants and manufacturers. Such rates do not act as a stimulus to trade in general any more than high call rates act as an immediate check to overexpansion.

It is not only in our domestic trade that the country suffers through the want of a discount market. Without bank acceptances we are at a distinct disadvantage in connection with our foreign trade. Our importers, unable to open credits with their banks, as is done abroad, are not in a position to finance their purchases upon as favorable a basis as the importers in other countries, as English cotton spinners, for example. The English spinner about to purchase cotton in America arranges for his bank to accept sixty or ninety days' sight bills drawn on it by the American shipper. The latter draws his bills on the English bank and attaches the documents covering the shipment, such as the bills of lading, insurance certificates, invoices, etc. He then sells them to a New York bank, thereby receiving immediate payment for his cotton. The New York bank forwards the bills to its London correspondent, which presents them for acceptance to the bank upon which they are drawn. Upon the acceptance

of the bills the documents are delivered to the accepting bank, which then turns them over to the spinner upon whatever arrangement has previously been made. The accepted bills are discounted by the New York bank in London and the proceeds placed to its credit there. The New York bank can afford to pay a high rate for such bills, as they are drawn on prime bankers, rendering certain their ultimate payment. The purchase of the bills does not, moreover, necessitate any outlay of money, as against the credit to be received through the discount of the bills the New York bank can immediately sell its checks on London.

Without such banking facilities—that is, the ability to arrange with his bank to accept time bills drawn on it by a foreign shipper, the American importer is compelled to finance his purchases in either one of two ways. He may pay for the goods at once by remitting funds direct to the shipper. This, however, ordinarily necessitates the negotiation by the importer of a loan on his promissory note. If he is not in a position to secure such an advance he must shift the burden of providing funds to finance the shipment, from the time it is forwarded until it is to be paid for, upon the foreign shipper, who is then in a position to exact terms more favorable to himself through an adjustment of prices. The practice in connection with this method of making payment for foreign purchases is for the shipper to draw his draft on the American importer and turn it over to his banker to forward for collection. Such drafts, drawn as they are on individual importers and not on banks whose standing is well known abroad, must be sent for collection since there is no general market for

them. Practically the only way in which a foreign shipper can realize immediately on bills of this character is to dispose of them to his own banker or get him to make an advance on them.

Either of these two methods of financing our imports is expensive even when the time between the shipment and the receipt of the goods is short. When the time is much longer, as in the case of imports from South America and the Far East, the cost is almost prohibitive—that is, so great that we can not compete on an even basis with foreign buyers. In fact, we might be practically excluded from these markets if a makeshift were not possible. Our importer gets around our lack of banking facilities by having his bank arrange a credit with its London correspondent. He receives an undertaking, called a commercial letter of credit, giving the terms of the credit—that is, the name of the London bank upon which the bills are to be drawn, the amount which may be drawn, the character of the goods which are to be purchased, the tenor of the bills, and the documents which must accompany them. On the strength of such a letter of credit, the shipper in South America, for example, is able to dispose of his bills on London and thus receive immediate payment for his goods. The local bank which buys the bills sends them with the documents to its London correspondent, which presents the bills to the bank on which they are drawn—that is, the bank with which the credit was opened. Upon the acceptance of the bills the documents are delivered. They are then sent by the London accepting bank to the New York bank which opened the credit and the latter delivers them to the importer against his trust receipt.

Twelve days prior to the maturity of the bills in London the New York bank presents a statement to the importer indicating the amount of pounds sterling which must be remitted to London to provide for their payment at maturity or rather a bill stated in dollars for the amount of pounds sterling drawn under the credit. In this purchase of exchange the importer makes payment for his goods. This method while workable is obviously cumbersome, yet it is practically the only one which the American importer can follow in connection with such imports. It is expensive for the importer, for not only must he pay his bank a commission for arranging the credit, but there is included in this commission a charge made by the London bank for its acceptance. Further than that the importer must take a material risk in exchange. At the time a credit is opened the cost of remitting, say £10,000 to take up the bills in London, might be only $48,600, or at the rate of $4.86, whereas by the time the bills actually mature exchange may have risen and cost him $4.87, or $48,700.

As a result of the inability of our banks to finance imports through the acceptance of time bills, American importers are, then, made dependent to a large extent upon London, and are required to pay London a considerable annual tribute in the way of acceptance commissions. This practice not only adds to the importance of London and militates against the development of New York as a financial center, but it at the same time works serious injury to our export trade. Since time bills can not be drawn on our banks from foreign points against shipments of goods to the United States, there are conse-

quently in such foreign countries very few bills which can be purchased for remittance to the United States in payment for goods which have been bought here. In other words, under our present banking system our imports do not create a supply of exchange on New York, for example, which can be sold in foreign countries to those who have payments to make in New York. This means that our exporters are also, to their great disadvantage, made dependent upon London. It means that when they are shipping goods to South America and to the Orient they can not, when they are subject to competition, advantageously bill them in United States dollars. They naturally do not care to value their goods in local currency—that is, in the money of the country to which the goods are going—so their only alternative is to value them in francs or marks or sterling, preferably the latter, owing to the distribution and extent of British trade, creating throughout the world, as it does under the English banking system, a fairly constant supply of and demand for exchange on London. When we come to bill our goods in sterling, however, it is at once seen that our exporters are obliged to take a risk of exchange, which is a serious handicap when competing with British exporters. Our exporters who are to receive payment for their goods in sterling must previously decide on what rate of exchange will make the transaction profitable. If, in an effort to safeguard themselves against a loss in exchange, they calculate on too low a rate for the ultimate conversion of their sterling into dollars, their prices become unfavorable compared to those made by British exporters and they lose the business. If they do not calculate on a suffi-

ciently low rate they get the business but lose money on the transaction through a loss in exchange.

The prohibition of bank acceptances not only acts as a hamper upon our domestic and foreign trade, but is detrimental to our banks as well. It is the small country bank which is chiefly affected. The business of the country bank, so far as the employment of its funds is concerned, may be divided into two classes—that which relates to advances to local customers and that connected with the investment of its surplus. It is in respect to the latter that the matter of acceptances is important. Under the present limitations of the national bank act there are three principal ways in which a country bank may render its surplus funds productive. It may deposit them with its reserve agent. This means a low interest return, too low in fact to permit of only a relatively small amount being thus employed. It may invest in bonds. In this way an increased interest return can be secured, providing a wise selection of securities is made, but it partakes of the nature of speculation. The third way is to buy commercial paper. Such purchases give an ample interest return and there is no savor of speculation. Even this method of employing a bank's funds, however, is far from satisfactory. It means the investment in a security for the strength of which the bank must depend on the word of note brokers, the rating of the mercantile agencies, or the opinion of some correspondent bank. It means, furthermore, the tying up of the bank's funds for a fixed period. If national banks were permitted to accept time bills the country bank could then invest its funds in paper bearing the guaranty of some great bank with whose standing it

is perfectly familiar. Risk such as now has to be taken would be eliminated. What is vital, however, is that with a national discount market an investment in a bank-accepted bill is one which could be realized upon immediately. Commercial paper and bank acceptances are both discountable. The prime difference between them, as affecting a country bank, is that they are not both readily rediscountable. Herein probably lies the reason for the strong prejudice against rediscounts which exists among bankers in the United States. In this country when a bank discounts a piece of commercial paper it is discounting something which for its security depends solely on its maker. Should the bank desire to realize on this paper it could do so by rediscounting it, but such a rediscount would be practically equivalent to a loan to the bank on the strength of its own name. In other words, to rediscount its commercial paper would affect a bank's credit. To ask for a rediscount is to ask for accommodation. This would not be the case with bank-accepted bills. If such bills were discounted by a country bank as a means of investing its surplus and it was desired to realize on them such a rediscount would be made not on the name of the country bank, but on the name of the accepting bank. A rediscount in this instance would not constitute a loan to the country bank and would have absolutely no effect on its credit. It would merely indicate that some more profitable business had arisen in which to employ its funds or that it was desirous of increasing its reserve.

Since the reserves of interior banks are so largely concentrated with them and it is essential that they keep their assets in an especially liquid condition, the prohibition of

bank acceptances works injury to the banks at the country's financial center, New York, in a different way. It deprives them of what London banks, for example, have—that is, a mass of the soundest securities against which to loan their money on call or in which they may invest their funds for very brief periods—bills of exchange, covering genuine commercial transactions, bearing the acceptance of prime bankers. Unquestionably such securities as a basis for loans are preferable to stocks and bonds, but without them New York banks must have recourse to day-to-day loans on the Stock Exchange. Moreover, when the demand for such loans is limited, New York banks are forced into the keenest kind of competition, a competition which, as has been pointed out, is not only of little benefit to trade but which, through the lowering of the money rate, actually stimulates speculation. Furthermore, without a steady money rate such as exists in countries possessing discount markets, New York banks are left with no reasonable or satisfactory basis upon which to fix a rate of interest to pay for the deposits of country banks. In London interest on bank deposits is fixed at a certain percentage below the Bank of England discount rate, usually 1½ per cent—that is, a rate which fluctuates with the value of money and normally leaves a certain margin of profit to the London bank. The same practice is followed in all the great financial centers of Europe. With us, country banks receive a fixed rate of interest for their deposits, usually 2 per cent, the year around, regardless of fluctuations in the value of money. The unscientific nature of such a rate is obvious. When the call loan rate is high country banks do not receive

interest in proportion to the value of their deposits. When it is low the New York banks pay more interest than the deposits are worth. In the latter instance the New York banks are forced into injurious competition with one another. They are in much the same position as competing railroads were earlier in our history, with results similarly baneful. With the railroads it was worth while to secure traffic even at a losing rate, as no matter what the return it helped if only a little toward meeting fixed charges. Oftentimes with the New York banks to-day any rate which they can secure for their money whether losing or not is acceptable as helping to meet this fixed interest charge on bank deposits. To pay 2 per cent for deposits and to keep a 25 per cent reserve a bank must loan its money at 2¾ per cent to come out even, taking into consideration the actual expense of making and recording the transaction. It is better to loan at 1¾ per cent, however, than to let the money lie idle. It is better to lose 1 per cent than to lose the entire 2¾ per cent, as would be done in case no loans at all were made, clerk-hire being just as much a fixed charge as interest. With the amendment of the national bank act, to permit the acceptance of time bills, such ruinous competition would cease. The funds of the banks would come to be principally invested in trade paper and stock-exchange loans would be relegated to a position of secondary importance, as in London and on the Continent. The field for the investment of their deposits would be greatly broadened, to the benefit both of the banks and trade in general.

X To remedy this primary defect in our banking system, to make possible the financing of our domestic and foreign

trade along the lines which have proved so advantageous in other countries, to provide negotiable paper of a character suitable to the investment of foreign funds, paper which can not only be discounted but rediscounted, to give trade the advantage of bank surpluses accumulated both in the country at large and in New York, to lessen the evils of speculation, to afford a reasonable basis for the calculation of interest rates on bank deposits in central reserve cities, to bring New York into the circle of those financial centers between which funds move naturally as discount rates rise or decline, to secure the advantage of the competition of foreign capital for our trade paper, can be put in the way of accomplishment by the insertion of a paragraph or two in the national bank act.

To permit bank acceptances would not require the revision of the entire bank act. To remove the barrier to scientific banking, as it is known abroad, no complicated piece of legislation would be necessary. Time only would be required for the development of a great national discount market.

The establishment of a central government bank is not a prerequisite to the legalization of bank acceptances nor to the giving of utility to such acceptances. The chief value of such banks lies in their great resources, which enable them to rediscount bills and make loans against bills or other securities without practical limit at all times, thus enabling other banks temporarily to realize upon their assets should occasion require. That is the function of a central bank. If any bank is sufficiently powerful to do this and is willing to content itself with small profits through the keeping of a large reserve it can come to exer-

cise the functions of a central bank. There is no necessity of such a bank being the Government's sole financial agent. It is not this which gives the Bank of England its power. It is rather the knowledge that the Government, realizing the size of the burden which the Bank is bearing and how important its safety is to the whole financial fabric of the country, stands ready to assist it in case of need. Past crises have been met by the Government authorizing the Bank of England to make an extraordinary issue of notes. Certainly our Government can be counted upon to render like assistance to a national bank similarly placed. In fact, we already have a law providing for an issue of emergency notes under the sanction of the Government.

If, moreover, we are to judge by the Bank of England, provisions for an elastic currency are not essential to the existence of a central Bank. It is true that the Bank of England has a large amount—£56,327,085 notes—outstanding, but of these £37,877,085 are on account of the Government—that is, they are nothing more than paper representing an equivalent amount of gold, being exactly similar to our own Government gold certificates. Of the remainder, £11,015,100 are based on £11,015,100 government debt. The balance, £7,434,900, is based on "other securities." This balance, however, is not subject to periodic fluctuation. From day to day the only way the Bank of England can increase its note issue is by receiving into its vaults an equal amount of gold.